Core Principles for Effective Banking Supervision

Introduction

The Basle Committee on Banking Supervision[1] recently released its Core Principles for Effective Banking Supervision. This article provides some background to this development, looks at the content of the Core Principles, how they are intended to be used and how Australian banking supervision measures up.

Background

Over the past few years, national and international regulatory bodies have intensified their co-operative efforts to strengthen the international financial system. Recent activity in this area was encouraged by the Heads of Government of the G-7 countries at their meeting in Halifax, Canada, in June 1995. The Mexican and Barings crises early in 1995 were the catalysts for the G-7 leaders to call for increased international co-operation to develop globally integrated 'safeguards, standards, transparency and systems necessary to monitor and contain risks'.

The need for international co-ordination of the efforts of supervisors of national financial systems had been recognised for over twenty years. The collapse of Germany's Bank Herstatt was instrumental in the formation of the Basle Committee on Banking Supervision. The securities and insurance regulators later followed suit (the International Organisation of Securities Commissions was formed in 1984 and the International Association of Insurance Supervisors in 1994). In 1996, these three international groupings created the Joint Forum on Financial Conglomerates, to consider the supervision of groups containing banking, securities and insurance entities.

In 1996, the International Monetary Fund (IMF), reflecting its increased interest in supervisory matters, published research[2] which pointed to financial instability and inadequate supervision of banks as important determinants of economic instability. The

1. The Basle Committee on Banking Supervision was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, Switzerland where its permanent Secretariat is located.
2. Lindgren, C-J., G. Garcia and M. Saal (1996), *Bank Soundness and Macroeconomic Policy,* International Monetary Fund.

research showed that 133 of the IMF's 181 member countries had experienced banking problems in the previous fifteen years and that no category of country was spared. The Board of the IMF accepted that the soundness of the financial sector was essential for macro economic stability and that IMF surveillance could assist in identifying potential vulnerabilities in a country's monetary and financial systems. The IMF felt that for its surveillance to be effective its staff needed a general statement of the broad principles likely to promote stable and sound financial systems.

At the Lyon Summit in June 1996, the G-7 Heads of Government agreed that better prudential regulation, particularly in emerging economies, was essential for preserving stability in financial markets, and urged greater efforts by national and international agencies to achieve this goal.

In response, the Basle Committee prepared a draft document setting out core principles for an effective supervisory system. In the process, it consulted widely with banking supervisors from a range of countries, including Australia. The G-7 meeting in Denver in June 1997 endorsed these principles and the final version was presented at the annual meetings of the World Bank and International Monetary Fund in Hong Kong in September.

The Principles

The Core Principles comprise twenty-five minimum requirements that need to be met for a supervisory system to be effective. The Principles (set out in full in the Attachment to this article) are divided into seven major groups.

Preconditions for effective banking supervision. The first Principle highlights the need for a clear, achievable and consistent framework of objectives and responsibilities for the agencies involved in banking supervision. It notes the necessity of a suitable legal framework for bank supervision and for the sharing of information by all relevant agencies.

Licensing and structure (Principles 2 to 5). These Principles focus on the licensing process, the ownership structure and the scope of business of banks and banking groups. The system of supervision must be based on a banking licence in order to identify supervised institutions clearly; and the use of the word 'bank' in business names should be confined to these supervised institutions, to prevent confusion amongst depositors. The licensing process should include an assessment of ownership structure, management and operating plans. Supervisors should be able to review major acquisitions or investments by a bank.

Prudential regulations and requirements (Principles 6 to 15). These Principles emphasise the need to identify the various types of risk confronting a bank, and ways of ensuring that these risks are properly monitored and controlled. The development and enforcement by supervisors of prudential guidelines are integral parts of this process. These guidelines should relate to capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management and internal controls, and can be quantitative and/or qualitative. Internal controls should include procedures which aim to prevent the bank being used by criminal elements.

Methods of ongoing banking supervision (Principles 16 to 20). These Principles say that both on- and off-site supervision should be used, with the latter including analysis of reports and returns from banks and their affiliated entities, on a consolidated as well as an individual basis. Independent validation of data is essential and regular contact with management is necessary to ensure that the operations of the bank are fully understood.

Information requirements (Principle 21). According to this Principle, each bank must maintain adequate records drawn up in accordance with consistent accounting policies that enable the supervisor to obtain a true and fair view of the financial condition and profitability of the bank, and must publish regular financial statements that fairly reflect its condition.

Formal powers of supervisors (Principle 22). This Principle stipulates that supervisors must have adequate powers to bring about corrective action if banks fail to meet prudential standards, or the interests of depositors are threatened.

Cross-border banking (Principles 23 to 25). These Principles review the respective roles of home and host supervisors, and stress the need for supervision on a global consolidated basis and for powers to share information with other supervisors.

Use of the Principles

The Core Principles provide a benchmark for international agencies and groups, especially in relation to emerging market economies. Both the World Bank and IMF are emphasising to emerging economies the importance of sound financial systems and the need to build effective supervision. Assistance programs are likely to increasingly require that systems of bank supervision be brought up to international standards. The Principles delineate those standards, providing an objective target for both the agency and the country concerned.

Bank supervisors can use the Principles both as a basis for self-assessment, and when judging the supervisory standards applying in other countries. The latter is important when considering applications for banking authorities by foreign banks. Australia, like most countries, requires that such applicants be supervised at an internationally accepted standard in their home countries.

Supervisory authorities around the world are being encouraged by the Basle Committee to endorse the Core Principles, not later than October 1998. Endorsement will include an undertaking to review current supervisory arrangements against the Principles and to initiate a program designed to address any material shortcomings as quickly as practicable within their legal authority. Implementation of the Principles is to be surveyed by the Basle Committee and reviewed at the International Conference of Banking Supervisors in Sydney in October 1998. Regional organisations of which Australia is a member, such as the SEANZA Forum of Banking Supervisors and the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), may have a role in promoting formal endorsement of the Principles and in monitoring implementation by their members.

Australian Bank Supervision

Australia complies with almost all of the Core Principles. This is hardly surprising given that its regime for supervising banks has been developed in the light of international best practice. In the case of Principle 15, which refers to the need for powers to combat money laundering, Australia complies, but the relevant regulatory authority is Austrac rather than the Reserve Bank.

Nevertheless, there are two areas where a literal interpretation of the Principles could raise doubts about Australia's compliance:

- Principle 3 requires that the licensing process include (*inter alia*) *an assessment of the bank's directors and senior management.* The Basle Committee interprets this to mean that all directors and managers, whether appointed at establishment or subsequently, should be subject to a 'fit and proper' test. The aim is to ensure that these personnel have the necessary ability, experience and integrity to operate a bank. In Australia, most local banks are large public companies listed on the Stock Exchange, and subject to the scrutiny which comes from a broad range of shareholders (as required by our ownership rules). In these circumstances, the Reserve Bank has not sought formal powers of approval over senior management appointments. It does, however, require prior notification of board appointments.

- Principle 25 requires *the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions*. The Australian policy of allowing foreign banks to carry out banking type operations in Australia as so-called 'merchant banks' is inconsistent with this Principle. The Reserve Bank is not in a position to provide information to home country supervisors on the activities of these merchant banks in Australia since it neither authorises nor supervises their activities. In its submission to the recent Financial System Inquiry, the Bank noted that this situation, which is a hangover from the days before foreign banks were able to apply for banking authorities, is anomalous, and recommended that all foreign banks operating in Australia should be required to seek Australian banking authorities. The Inquiry did not accept that recommendation because of a concern that requiring merchant banks to seek banking authorities might lead to a reduction in competition. The Government has endorsed the Inquiry's view on this matter.

Attachment

List of Core Principles for Effective Banking Supervision

Preconditions for effective banking supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.
3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.
4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential regulations and requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that banks undertake, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these

requirements must not be less than those established in the Basle Capital Accord.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.
9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.
12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of ongoing banking supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.
19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examination or use of external auditors.
20. An essential element of banking supervision is the ability of the supervisors to supervise the banking organisation on a consolidated basis.

Information requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal powers of supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border banking

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.
25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.